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China Poised for Investment and Import Surge

After four years of austerity and readjustment, China appears ready for a modest dose of reflation. Capital investment and government expenditures in general were sharply reduced in 1981 and held down last year as well. However, spending is projected to rise this year. Two major complexes have been identified for accelerated development in 1983-85: machinery production in the Shanghai region and coal and railroad development in northern China. At the same time, less emphasis will be given to the special economic zones along the coast.

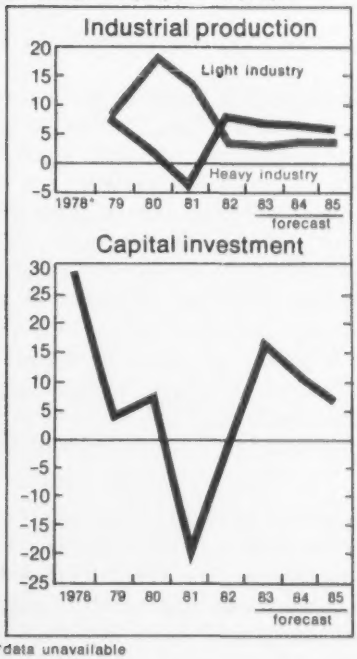
China is overdue for a new surge in machinery and technology purchases from Japan, the United States, and Western Europe. The financial resources have been there for some time. During 1981-82, export growth—along with import restraint and increased income from services and transfers—produced a total current-account surplus of at least $6 billion. By the end of last September, foreign-exchange reserves had climbed above $9 billion—an embarrassing level for a poor nation seeking long-term development loans and economic assistance. Bottlenecks were a serious problem during the last construction boom, but readjustment has increased domestic capacity to absorb Western machinery. Furthermore, the current weakness of world trade makes this an optimal time for purchasing capital goods.

China's expansionary phase might have begun in 1982 but did not. There were a number of restraining economic conditions: High interest rates, foreign protectionism against Chinese manufactured goods, and global economic uncertainty all tended to reinforce the financial conservatism of the present Party leadership. In addition, the last year has seen a major reorganization of the government bureaucracy—another reason for postponing rapid growth in construction until certain officials were retired. However, political forces should not seriously inhibit this push to build new infrastructure and modernize technology.

All in all, the mid-1980s should be a period of growth and stability for China; improvements in industrial balance and continuing growth in agricultural output should sustain GNP growth at around 5% per year. Economic conflicts among central planners, provincial authorities, and managers over investment funds and foreign capital are inevitable. But these strains simply reflect real tradeoffs under modernization and should be manageable over the next three years. Over the longer run, however, more significant changes in the Chinese economic system will be necessary—primarily in the price mechanism, the allocation of labor and investment, and the management of foreign trade.

Industrial output and capital investment in China

percentage change (year over year)



*data unavailable

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Falling pound may force the hand of U.K. government.

The pound sterling has been on a downtrend again after the short pause that followed November's interest-rate hike. Since the end of November it has slipped from DM 4.01 to DM 3.70 and—even against a weaker dollar—from $1.62 to $1.57. These figures compare with DM 4.32 and $1.93 at the start of 1982. Britain's economy has not yet shown any changes that would justify this rapid fall; indeed, domestic inflation is still falling rapidly, with the latest (November) figure showing a year-over-year rate of just 6.3%. Several negative influences, however, have led to pre-emptive selling of the pound. These include: forecasts for 1983, which show output picking up; a declining current account; uncertainties over the course of oil prices and over the timing and outcome of the next election; and government statements last autumn that sterling seemed to be overvalued. If the pound continues to fall, the government will have to give the currency further protection. Its hope is that interest rates will soon fall in the United States and elsewhere, so that leaving U.K. rates unchanged will be enough to protect the pound. If rates elsewhere remain at today's levels, however, the Bank of England would push U.K. rates up in order to widen the differential in favor of sterling.

Inflation surge in Switzerland should be short-lived.

Although the annual rate of inflation in Switzerland—now around 6%—currently exceeds that of the United States and Germany, there appears to be little reason for concern over possible long-term consequences. In fact, both short- and long-run forces seem to be operating to limit inflation. In the near term, falling mortgage rates, declining gasoline prices, and a stronger currency in terms of the dollar will help to contain price increases. For the longer run, central-bank money has grown at an average annual rate of only a little over 3% since 1977. As a result, there does not seem to be any significant shift away from the low levels of inflation enjoyed by Switzerland since the mid-1970s. Thus, there is little reason to suppose that Swiss interest rates will not decline in line with an expected fall in U.S. and German interest rates. Indeed, at the beginning of December the Swiss National Bank announced a half-percentage-point cut in its key lending rates. Moreover, in the long run, continued low inflation and a substantial current-account surplus will be reflected in a strong Swiss franc.

Moderation marks Spanish approach to unemployment and economic growth.

The new Socialist government of Felipe Gonzalez took power in Spain in early December facing an unemployment level in excess of 2 million. It has stated that its prime objective is to create 800,000 jobs. Nevertheless, although a full economic program is not yet in place, most policy statements have pointed toward a moderate stance. The first major policy action was an 8% devaluation of the peseta —a move that followed substantial speculation and large reserve losses. Policymakers hope this move will help stimulate exports—and therefore the economy—although its success will depend on the ability to contain cost increases. In other actions the government increased cash reserve requirements for banks by one percentage point, raised oil and gasoline prices by more than 20%, and reduced the work week. In 1983 the new administration faces the problem of raising growth above the official estimate for 1982 of 1.3% while tackling the public-sector deficit, which is estimated to have reached 900 billion pesetas last year—some 4.5% of GDP.

Mexico begins tough adjustment program.

The Mexican government is in the initial phases of adjusting its economy to conform with an international support program tied to an IMF agreement. On December 23, 1982 the IMF approved a three-year $3.9 billion extended arrangement. Approval of the IMF program is contingent upon Mexico's securing $5 billion in net new financing in 1983 from commercial banks and another $2 billion from official sources. In addition, some $20 billion of public-sector debt due to commercial banks over the period August 23, 1982 to December 31, 1984 must be restructured. The key aim of the Mexican adjustment effort is to cut the public sector deficit from 16.5% of GDP in 1982 to 8.5% in 1983 and subsequently

down to 3.5% by 1985. Implementation of this program includes tax increases, spending and wage restraints, cuts in subsidies, and removal of price controls. Money and credit are also being controlled and interest rates are being allowed to rise in order to capture savings. The exchange rate has also been allowed to float and last week reached 150 pesos per U.S. dollar. These measures are certain to produce improvements in the fiscal and balance-of-payments accounts this year, but at considerable sacrifice—real GDP is likely to decline by some 3%-4% in 1983, after near-zero growth last year.

Range of medium and heavy industries planned for Malaysia.

Malaysian Prime Minister Mahathir Mohamad has undertaken a major shift in economic policy designed to develop medium-to-heavy industry. The new policy reflects both policymakers' desire to reduce the country's dependence on primary commodities and an acknowledgment of the limited growth potential in the labor-intensive export industries on which much of Malaysia's industrial development has focused up to now. Among the projects contemplated are: two sponge iron plants, a methanol plant, an ASEAN ammonia-urea plant, two petroleum refineries, a paper-pulp plant, expanded cement-production capacity, a cold-rolled sheet steel mill, and an automobile plant. Most of these will draw heavily on Malaysia's oil and gas resources. Furthermore, many of the projects are likely to involve Japanese or Korean investment. The auto manufacturing project is now in the limelight. Production is planned for the domestic market, with tariff protection as necessary. Since Malaysian demand for new autos is currently only about 100,000 per year, the project will have to capture a dominant share of the market. The degree of protection might therefore have to be large, and the economic viability of the project is certain to be controversial.

Efforts to hike public-utility prices in Thailand hit wall of opposition.

The government of Thailand has encountered severe problems in implementing badly needed policy reforms aimed at bringing prices charged by public utilities more in line with costs. Consequently, subsidies to ailing and inefficient state enterprises remain a serious drain on the Thai budget at a time when the generally depressed state of the economy is causing large revenue shortfalls and widening deficits. In late November, public protests forced the government to rescind an increase in the bus fare. The bus company alone has accumulated an estimated 3.5-billion baht loss over the last seven years—largely because of its inability to adjust prices quickly in response to higher fuel and other operating costs. Steps to improve the profitability of public enterprises are critical to Thailand's structural adjustment. But, in early December, in the wake of the protests over the bus fare increase, the Thai Communications Ministry reportedly postponed an earlier decision to raise politically sensitive passenger-train fares—an action that could result in a sharp increase in the losses of the state railway.

Cameroon's deficit financing expected to remain manageable.

The current state of Cameroon's economy must be characterized as mixed. Oil output is estimated to have risen to 106,000 b/d in 1982 from 88,000 b/d the year before, but oil well development has slowed. Earlier projections of 200,000 b/d annual output by 1985 have been scaled back, and it now appears that production may stabilize at the 140,000-160,000 b/d level. Plans for an LNG plant have been shelved in view of lower reserves than previously estimated. Moreover, both the aluminum and timber industries are experiencing severe financial problems. By contrast, substantial public-sector outlays continue to feed the construction and road-building industries. In the external sector, only a minor improvement in the current-account deficit from the $375 million estimated for 1982 can be expected this year. Nevertheless Cameroon's relatively "underborrowed" financial condition and the continued inflow of direct investment should ease any deficit financing problem and contain debt-service obligations within manageable limits.

Consumers Not Ready to Lead Recovery

The sharp rise in housing activity in the past few months sparked a general expectation that the end of the recession—if not already here—was at least at hand. However, the housing sector is not large enough to lead the economy into a recovery by itself. As always, consumer spending remains the key to sustained expansion. But recent evidence indicates that consumers may be inclined to keep a tight grip on their wallets a bit longer.

A strong Christmas shopping season would have done much to reinforce the idea that a recovery was about to begin. But last week, the Commerce Department reported that retail sales fell by 0.4% in December. After three consecutive increases in September, October, and November, the news came as a major disappointment. Much of the drop in retail sales can be blamed on auto sales—down 4.1% in December after a 12.5% jump in November, thanks to the elimination of special sales incentive programs. The performance of other sectors was steadier—although weaker on balance—with a rise of 0.5% in December on the heels of November's 0.4%.

Special conditions such as auto rebates can lead to temporary spurts in sales. However, in the longer run, the growth in personal after-tax income acts as a constraint on overall consumer spending. Over the last six months, consumers' disposable income grew at a 7% annual rate, while their expenditures grew at an 8.7% annual rate. This higher rate of spending could only have come about because the share of income going to savings fell from 6.6% in June to an estimated 5.8% in December.

If consumers felt confident about their own economic futures, this drop in the savings rate would not be particularly troublesome. However, with the unemployment picture continuing to worsen and unlikely to improve much before 1984, consumers probably will want to rebuild their savings as a precautionary measure. The Conference Board's indexes of consumer sentiment and buying plans fell in December. Moreover, consumers have continued to exercise caution in their use of credit and have been unwilling to take on debt faster than the growth in their incomes.

In addition to the fear of unemployment, there are also positive incentives for consumers to save. Despite their declines of the last several months, interest rates remain high on a historical basis. And deregulation has allowed financial institutions to create high-yielding instruments that have been quite favorably received.

Thus, any gains in spending over the next several months can be expected to be moderate, at best, as consumers attempt to shore up their savings. This higher level of savings will be helpful in financing the estimated $200 billion federal budget deficit. But to the extent that consumers do increase their saving, the onset of the economic recovery may be delayed.

Douglas L. Bendt

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE				
			6 months ending	change from year earlier	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	u c lio
Africa	Algeria	Budgeted expenditure for 1983 is $21.5 billion—16.4% higher than last year's.	Oct.	— 20%	36.0*	1,935	Nov.	2,499	—35%	1.0	
	Cameroon	Oil output projected to rise to 125,000 b/d in 1983.	Feb.	+ 20%	7.8	890	May	28	—68%	0.3	
	Egypt	Official projects foreign loan requirement of $6 billion for 1982-87.	June	— 24%	30.8	710	Sept.	716	—16%	1.3	
	Ethiopia	Drought in Tigre region affects food production.	March	— 6%	4.2	132	Nov.	205	—20%	3.2	
	Gabon	Elf Gabon's discovery of two new oil fields should halt steady oil output decline.	Dec '81	+ 10%	3.4	6,180	July	379	+43%	n. a.	
	Ivory Coast	Austere 1983 budget shows 25% capital outlay reduction, 5% increase in operating budget.	Aug.	— 16%	9.8	1,190	Sept.	2	—76%	0.0	
	Kenya	Factories face shortages of industrial raw materials and spare parts.	April	— 6%	6.6	383	Nov.	179	—33%	1.1	
	Madagascar	Serious deterioration of roads and railways impedes development.	Dec. '80	— 27%	3.8	420	May '80	9	—80%	0.2	
	Morocco	Economic growth was 4%-5% in 1982, a sharp turnaround from 1981's 1.3% decline.	July	— 16%	15.2	735	Oct.	158	—13%	0.4	
	Nigeria	Incomes-policy guidelines extended to 1983.	Oct.	+ 22%	86.8	1,125	Oct.	1,543	—70%	0.9	
	South Africa	Last year's tighter monetary policy should result in greater price stability in 1983.	Oct.	— 17%	77.5	2,573	Nov.	908	+34%	0.6	
	Tunisia	State budget for 1983 projects an outlay of nearly $3 billion—up 15% from 1982.	July	— 14%	8.1	1,240	Nov.	581	—12%	1.9	
	Zimbabwe	Wage-control regulations amended to permit selective increments and dismissals for economic reasons.	Aug.	— 11%	6.7	870	Nov.	137	— 5%	1.1	
Middle East	Iran	Government to continue policy of economic austerity despite rising oil revenues.	Oct.	+163%	n. a.	n. a.	June '80	15,478	+41%	16.5	
	Jordan	Government to raise large Eurodollar loan.	April	+ 15%	4.5	1,341	Oct.	991	—13%	3.5	
	Kuwait	Huge $1.3 billion petrochemical project reportedly cancelled.	May	— 30%	24.3	17,350	Nov.	5,586	+50%	7.2	
	Qatar	Long-term development focus to shift from industry to social services.	Oct.	— 12%	5.0*	23,000	Jan. '82	393	n. a.	2.9	
	Saudi Arabia	Government reported slowing down advance payments on some projects.	Oct.	— 35%	155.8	16,719	Nov.	28,898	— 8%	3.0	

*1980

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The Fed's Monetary Policy Dilemma

Last week's publication of the December monthly monetary data confirmed that in 1982 both M1 and M2 exceeded the upper end of the Federal Reserve's annual target growth paths. This is not really surprising, given the shift in monetary policy since October. However, market perceptions of the inflationary consequences of the new policy have recently changed.

For the past three months, concern over the weak economy and the conviction that money supply data were being distorted by technical factors—maturing All-Savers certificates and bank money-market accounts—have led the Federal Reserve to shift its concern from the management of monetary aggregates to reducing the level of nominal interest rates. Although the commodity, foreign exchange, and bond markets initially reacted quite favorably to this return to interest-rate targeting, their mood has now begun to change. Commodity prices, including gold, have begun to turn upward, the dollar has dropped precipitously, and bond yields have firmed.

These developments reflect not so much a lack of confidence in the new policy per se, but rather a disappointment that the growth of the monetary aggregates—however distorted they might be—has failed to slow down. The problem is that, by switching to interest-rate targeting, the Fed has given up its old instrument for reducing monetary growth—rising interest rates. Instead, it must hope that the external events that brought about the rapid money growth, such as buildups in precautionary balances, surges in stock and bond market volume, and the introduction of new deposit instruments, will naturally reverse themselves or be offset by countervailing external forces. It is the possibility that this scenario may not materialize, as well as the experience of the 1970s—suggesting that two consecutive years of rapid money growth spells a resurgence of inflation—that is currently fueling the market's apprehensions.

In lieu of a slowdown in money growth, the Fed's strategy for allaying the market's fears will become apparent when Chairman Volcker testifies before Congress on February 20. At that time, he will probably propose a set of money redefinitions. Although this gambit may "buy time," it will not solve the basic problem if money—however measured—continues to surge for several more months. In such an event, Fed policymakers will be forced to make a difficult choice: Either they can return to non-borrowed reserve targeting, at the risk that the ensuing tightening will cause short-term rates to rise; or they can continue to accommodate the money bulge, possibly heightening inflationary expectations and bringing about a steepening of the yield curve. Either option could easily lead to another cyclical downturn in the economy, defeating the purpose of the original policy change.

Carl Alan Batlin

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
of IMF dit, mil- of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	January 12, 1983		current monetary conditions	
0	Jan.-Oct. 1982 oil output averaged 682,000 b/d, 17% below 1981 period.	Dec. '80	+10%	Dec. '81	+16%	.2125	— 8%	Foreign-exchange reserves to Nov. down $1.2 billion.	Algeria
1	Cocoa and coffee stocks rise, reflecting slowdown in sales.	Aug. '81	+ 9%	July	+29%	.0030	—12%	Credit tightness continues.	Cameroon
58	Oil prices cut twice in December—by as much as $1.60 per barrel.	July	+17%	Sept.	+25%	1.2050	— 2%	Foreign-exchange reserves holding steady.	Egypt
29	Coffee earnings unlikely to rise markedly despite firmer prices.	May	+ 5%	Sept.	+ 9%	.4868	+ 1%	Credit restraint continues.	Ethiopia
12	Economic growth turns positive after period of austerity.	July '81	+ 7%	July	+ 21%	.0030	—12%	ECGD grants $100 mn. credit for Trans-Gabonais.	Gabon
69	Oil development slows; 1983 output projections lowered to 30,000 b/d.	July	+12%	June	+ 4%	.0030	—13%	Credit squeeze continues.	Ivory Coast
35	Severe foreign-exchange shortage causes delays in import license approvals.	July	+20%	Oct.	+14%	.0900	—19%	Bank lending rates increased to 16% from 14%.	Kenya
26	New foreign exchange allocations favor raw materials and spare parts.	May '81	+39%	n. a.	n. a.	.0028	—20%	Foreign-exchange shortage has caused payment delays.	Madagascar
50	Phosphate rock prices have held at $40 per ton since July 1982.	June	+ 9%	June	+12%	.1860	— 2%	Money supply growing steadily.	Morocco
0	New import restrictions cover all industrial and construction equipment.	Dec. '81	+17%	June	+ 5%	1.4967	— 5%	Foreign trade payments three months behind.	Nigeria
58	Slowdown in business activity is reducing demand for imports.	Oct.	+14%	Sept.	+26%	.9400	— 9%	Availability of funds improving.	South Africa
0	Oil output fell slightly last year.	May	+13%	July	+14%	1.6800	—17%	Gross foreign assets holding steady.	Tunisia
0	Aid disbursements should speed up, cushioning strained payments situation.	Oct.	+18%	Aug.	+12%	1.1100	—23%	Devaluation could add 6 pctge. pts. to consumer price level.	Zimbabwe
0	Oil output now 2.7 mbd—rose 34% during Jan.-Oct. from 1981 average.	Sept.	+19%	Feb. '81	+34%	.0120	— 4%	Foreign-exchange reserves up sharply in 1982 second-half.	Iran
0	Phosphate rock export prices fell about 13% during 1982.	Sept.	+ 7%	Aug.	+14%	2.8500	— 5%	Bank claims on government rising steadily.	Jordan
0	Oil output averaged 675,000 b/d for Jan.-Oct. 1982—31% below 1981 period.	Feb.	+ 7%	Sept.	+24%	3.4700	— 2%	Growth of money supply slowing.	Kuwait
0	Jan.-Nov. 1982 average oil output was 330,262 b/d, down 20% from 1981.	n. a.	n. a.	March	+50%	.3448	+24%	Foreign assets holding steady.	Qatar
0	Average oil output from Aramco fields reported down to 5.1 mbd in Dec.	Sept.	— 1%	Aug.	+20%	.2907	— 1%	Foreign-exchange reserves to Nov. down $3.34 billion.	Saudi Arabia

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World Interest Rates

market rates of Jan. 12, 1983; bond yields as of Jan. 7, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.74	10.00 intervention rate	11.50	9.50	5.00	18.00 penalty rate 21.00	5.00	4.50	5.50
Day-to-Day Money	8.50 January 13	15.00	11.00	8.45	12.75	5.85	19.00	5.50	1.00 1-month Euro-Swiss fr. rate	6.5625
Treasury Bills 91-day, Middle Rates	7.66	9.50	11.00	12.25	n. a.	n. a.	18.10 77 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	9.75 finance paper 15% tax w/h	10.615	11.40 Certified	n. a. Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.05	9.60 15% tax w/h	11.0625	11.40 Certified	not traded	6.50	20.00	no market	2.875	no market
Government Bonds Long-term, new and old issues, average yield	10.68	12.40	10.90	10.83	14.53	7.70	19.37	7.63	4.21	7.102
Industrial Bonds prime, long-term, new and old issues, average yield	11.55 Aa Industrials	12.50	13.29	13.29	15.72	7.90	19.49	8.26	5.62	6.38
Bank Short-Term Rate to Best Borrowers (prime rate)	11.00	12.00	12.00	15.50	14.80	9.00	20.75 ⅛ qtrly fee on outstdng.	7.50	8.50	6.00
Bank Time Deposits 3-month	8.125 Cert. of Dep.	9.875	11.6875	12.00	12.625	5.55	11.50	5.25 large deposits	2.50 residents only	3.75
Eurocurrencies 3-month, asked	8.8125	9.975	11.75	no market	22.25	5.4375	no market	4.9375	2.625	6.375
Exchange Rates—in U.S.$ rates floating against the $	—	.8190	1.5795	.021672	.1503	.4258	.000742	.3964	.5186	.00436
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	0.978 *D*	2.659 *D*	5.519 *D*	12.774 *D*	3.476 *P*	14.555 *D*	3.934 *P*	6.170 *P*	2.385 *P*

Eurodollar Deposits
(London, interbank, bid)
January 13

7-day	8.875
1-month	8.75
3-month	8.75
6-month	8.875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.530
U.S.-Canada Treasury Bills	−0.515
U.S.-Canada Finance Co. Paper	−0.138
Eurodollars-U.K. Local Auth. Deposits	+0.034

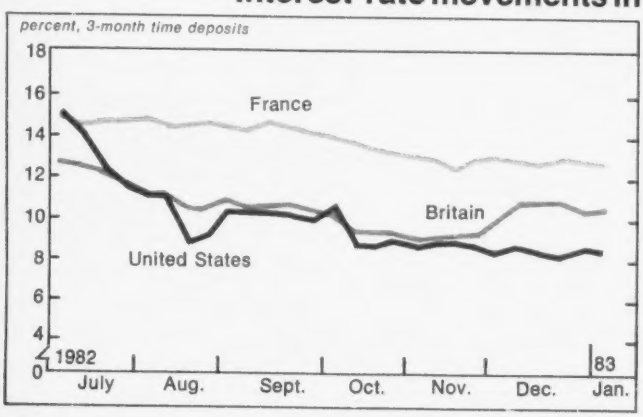
Eurobonds
(average yield on recent straight debt issues)

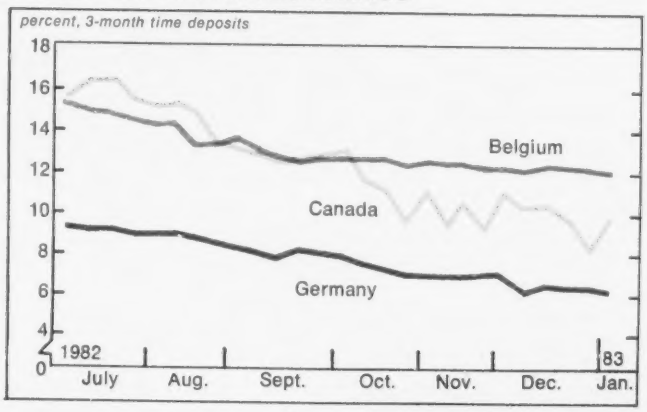
U.S. Dollar Bonds	
7 yrs. and under	10.70
Over 7 yrs.	11.00
DM Bonds	
7 yrs. and under	8.00
Over 7 yrs.	7.75

Gold Price
London afternoon fixing
480.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Interest-rate movements in selected industrial countries





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The Nature of the LDC Debt Problem

The following is adapted from remarks given by **William S. Ogden,** *Vice Chairman of The Chase Manhattan Bank, N.A., before the Manhattan Institute of Policy Research in New York late last year.*

In interpreting the so-called LDC debt crisis, the financial and popular press have often overlooked several critical points. First and foremost, the current LDC debt problem is a problem of *illiquidity* not *insolvency*. Second, the LDC debt difficulties represent a problem not just for the international banks, but for the entire world economy, since the dimensions of the current global recession are ultimately what is at stake. Finally, our collective capability to prevent the present liquidity crisis from escalating into a vicious circle of economic and political dislocations has frequently been underestimated. Liquidity problems are readily solvable. But they rarely solve themselves if ignored.

Liquidity not solvency

The tone of much of the media discussion seems to imply that LDC debt has been built to unserviceable levels. Undeniably, the current levels of debt are high. On the eve of the first oil price shock in 1973, the total foreign debt—public and private, long-term and short-term—of non-OPEC developing countries was slightly less than $100 billion. By the end of 1981, this total had grown to roughly $470 billion, and it is estimated that another $60 billion or so has been added in 1982. Commercial bank lending accounted for a large proportion of this increase.

These are extremely large numbers. But they must be put into perspective relative to the greatly expanded productive capacity of the LDCs. Contrary to some reports, relatively little of the increase in debt over the past eight years has been used simply to sustain consumption. Rather, most has underwritten increased investment.

I do not want to imply that the level of borrowing by the LDCs has been optimal or that it could have continued growing indefinitely at the pace of recent years. The developing countries as a whole have, in fact, been far too slow in adjusting their growth ambitions to the realities of a world economy grappling with disinflation. The resources borrowed have not always been utilized efficiently. But the debt buildup has not been wildly imprudent.

Why then is there an LDC debt problem? The problem arises out of the difference in debt-service capability in the short run versus the long run—between the actual ability to export and the capacity to produce for export. Neither borrowers nor lenders anticipated a prolonged recession in the industrialized nations—nor, for that matter, did the policymakers in the industrialized countries.

The fall of commodity prices and the worldwide recession have slowed dramatically the growth of exports from the developing countries and hence *temporarily* reduced debt-service capacity. Inflation expectations in financial markets have been slow to respond to disinflationary policies in the industrialized countries. This has resulted in unusually high real interest rates and thus temporarily increased debt-service flows.

Consequently, there has been a rapid deterioration in the capacity to service public debt as it is conventionally measured. The debt-service ratio for the non-oil developing economies as a whole—calculated as the ratio of interest and amortization on medium- and long-term debt to total exports of goods and services—has climbed from roughly 16% in 1980 to an estimated 25% in 1982. Of even greater significance, the ratio of interest payments on total foreign debt to total exports has increased from less than 8% in 1980 to an estimated 14% in 1982. For some of the major borrowing countries—particularly in Latin America—these indexes of debt-service burden are even higher, with total foreign interest payments running as high as 45% of total exports.

Even so, the immediate cause of the present liquidity problems of many developing countries is the increasing unwillingness of the international financial community to lend. In questioning the short-run debt-service capability of countries possessing a large foreign debt burden, the market has engineered an abrupt, relatively synchronized reduction in the availability of new foreign credits. This essentially guarantees the impossibility of normal debt service.

For many countries, particularly in Latin America, important segments of the market for foreign lending have virtually disappeared—in particular, regional bank participation in international loan syndication and private placements intermediated by the investment banks. Until debt-service uncertainties are resolved, the flow of available credit will be sharply curtailed. Moreover, the resolution of those uncertainties in many instances will entail debt reschedulings that will take a significant period of time to prove their workability.

The result is that there are now in place the basic elements of a classic liquidity squeeze: a rapid buildup of a stock of assets of relatively long maturity, funded by the issuance of debt of significantly shorter maturity; a global recession, which has temporarily thrown into question the ability of the debtor to service those debts; and a scramble on the part of many debt-holders

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The Nature of the LDC Debt Problem *(continued from page 7)*

to liquidate their portions of that debt. We have a serious problem. But it is a liquidity problem, not a solvency problem—unless one believes that the industrialized nations are doomed to long-term stagnation.

Bank viability

A second key point is that the most important problem arising out of the current LDC debt-service difficulties is not the viability of the international banks but rather the possibility of a significantly worsened world recession.

The international banks face a negligible risk of permanent default or debt denial, because sovereign borrowers cannot cease to exist. Permanent default implies both a long-term loss of access to international private capital markets and a sharply reduced ability to utilize the international financial service network that is essential to the ordinary conduct of foreign trade.

However, there are indeed risks in the present environment: risks of significant delays, both in reestablishing the creditworthiness of a number of borrowing countries and in securing adequate rescheduling agreements—plus risks of failure to adhere to those agreements once negotiated. For the sovereign borrowers, there is a risk of a prolonged period of severely curtailed imports and of a serious decline in the overall level of domestic activity. For the international banks, there exist both a risk of losing the freedom to manage a significant proportion of their asset portfolio and a risk of a moderate, temporary fall in earnings. But this latter risk in no sense implies a threat to the *viability* of the banks. Even in circumstances where the proportion of assets-not-serviced relative to principal would increase well beyond current levels, the proportion of assets-not-serviced relative to interest would be comparatively small.

There is no way that the present debt difficulties of the developing economies can be resolved without the provision of further credits. Balance-of-payments deficits must be reduced sharply. But they cannot be eliminated overnight. New credits are needed. The proportion of this credit deriving from public and multilateral sources is inevitably going to increase, but relatively large flows of credit from private sources are still essential. Assembling these needed credits in an environment in which important elements of the market want to reduce exposure will be difficult.

The immediate problem is not that the banks will not be repaid but that they may not be in a position to continue lending. And yet without significant net new lending to the developing countries, the economic adjustment required of them will be catastrophically abrupt. The economic dislocations entailed in such an adjustment would threaten a breakdown of the political consensus existing in those countries. This, in turn, would delay the adoption of the policies needed to reestablish creditworthiness. The impact of such a chain of events would by no means be contained within the developing countries themselves. We are members of an increasingly interdependent global economy. U.S. exports now total nearly one-tenth of our total gross national output, and more than one-third of those exports now go to developing countries that are critically dependent on continued access to private international credit markets. The loss of a significant proportion of those export markets would add markedly to our already appreciable unemployment lines.

Containing the problem

That, of course, is not an enviable prospect. Neither the borrowing governments, the international financial community, nor the multilateral institutions and governments of the industrialized nations can contain the current difficulties by themselves. However, it is well within our *collective* capability to prevent the present liquidity problems of the developing countries from escalating into a vicious circle of economic dislocations that would deepen and prolong the present global recession.

The borrowing countries must take strong measures to reduce their balance-of-payments deficits. It is inevitable that these measures will reduce economic growth—and in some cases actually lower the current level of economic activity.

The key responsibility of the private international financial community is to provide an adequate financing package to the countries with liquidity problems. To do so will require the cooperation of all segments of the private market.

The governments of the industrialized countries have no responsibility to guarantee a reasonable rate of growth to the developing economies at a time when the attainable rates of growth of their own economies are unreasonably low. These same governments have no responsibility to protect their banks from the consequences of imprudent behavior. But they do have responsibility for the provision of reasonable flows of liquidity on a global basis and for the provision of lender-of-last-resort facilities for their individual national banking systems.

The provision of reasonable flows of global liquidity is troublesome. This responsibility is exercised by central banks individually or, in some cases, collectively through the Bank for International Settlements and, at the government level, through the International Monetary Fund. Without a commitment to increased levels of multilateral credit to the developing countries in trouble, the availability of credit from private sources will shrink drastically. That would spell trouble for not only the banks but the entire global economy.